

DESCRIPTION OF
TAX MATTERS RAISED BY THE
PAYMENT-IN-KIND (PIK) PROGRAM
INCLUDING A DESCRIPTION OF
S. 446, S. 495, AND S. 527

Scheduled for A Hearing
on February 28, 1983

Before the
Subcommittee on Energy and Agricultural Taxation
and the
Subcommittee on Oversight
of the Internal Revenue Service
of the
Committee on Finance

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INTRODUCTION

The Subcommittee on Energy and Agricultural Taxation and the Subcommittee on Oversight of the Internal Revenue Service of the Committee on Finance has scheduled a hearing, to be held on February 28, 1983, on the tax matters raised by the agricultural commodities payment-in-kind (PIK) program. The hearing will consider specifically S. 446, introduced by Senators Jepsen, Dole, Grassley, Wallop, Durenberger, and Pryor, S. 495, introduced by Senator Baucus, and S. 527, introduced by Senators Grassley, Wallop, Bentsen, Boren, Symms, Roth, and Danforth.

The first part of this document is a summary of S. 446, S. 495, and S. 527 and other tax matters raised by the PIK program. The second part is a description of the PIK program. The third part is a description of present law relating to the tax matters raised by the PIK program. The fourth part is a description of the tax issues raised by the PIK program. The fifth part is a description of S. 446, S. 495, and S. 527, including revenue effects. The sixth part provides a description of prior Congressional action on the tax treatment of the PIK program.

I. SUMMARY

The Administration (Department of Agriculture) has adopted a payment-in-kind (PIK) program under which farmers are paid with commodities for diverting all or certain portions of their farmland from production.

S. 446 would permit farmers to defer the recognition of income from commodities, actually or constructively, received under the PIK program until the commodities are sold. The bill would treat commodities received under the PIK program as grown on the real property withdrawn from production under the program for purposes of determining whether the real property is used in an active farming (i.e., qualified) use as required by the estate tax current use valuation provision.

S. 495 would permit farmers to elect to defer recognition of income from commodities, actually or constructively, received under the PIK program until the commodities are sold. The bill would treat property withdrawn from production in exchange for a fixed payment under any Federal farmland removal program as used in an active farming (i.e., qualified) use for purposes of the estate tax current use valuation provision. Additionally, withdrawal of real property from production under the PIK program would not be construed to prevent satisfaction of the current use valuation material participation requirements.

S. 527 would permit farmers to defer the recognition of income from commodities, actually or constructively, received under the PIK program until the commodities are sold. The taxpayer would be treated as the producer of the commodity for all purposes of the Code and the Social Security Act.

The bill would treat real property removed from production under the PIK program as used in an active farming (i.e., qualified) use for purposes of the estate tax current use valuation provision. A maximum of three years of PIK participation could be considered as use in a qualified use.

The bill would also treat real property otherwise used in an active trade or business which is withdrawn from production under the PIK program as used in such a trade or business for purposes of the estate tax installment payment provision.

II. DESCRIPTION OF THE PAYMENT-IN-KIND ("PIK") PROGRAM

Overview

The Department of Agriculture's payment-in-kind ("PIK") program is a program for diverting from production land which otherwise would be used to produce crops of wheat, corn, sorghum, rice, and upland cotton. Under the program, producers will be provided a quantity of a commodity as compensation for diverting acreage normally planted in that commodity. As presently announced, the PIK program applies only for the 1983 acreage reduction program.

The PIK program is in addition to the previously established acreage reduction and price support programs available to farmers. The previous programs provide for cash, rather than in-kind, payments. Farmers must be participants in these cash payment programs as a condition of eligibility for the PIK program.

PIK Program

General rules.--Under the PIK program, farm producers generally may elect to divert from 10 to 30 percent of their crop acreage base¹ from active crop production in exchange for a payment-in-kind equal to an established quantity of the commodity normally grown on the property. The established percentage is the farm's program yield² times 95 percent for wheat and 80 percent for corn, grain, sorghum, upland cotton, and rice multiplied by the PIK acreage.

In lieu of the guaranteed 10 to 30 percent PIK diversion election, farmers may elect to divert the whole crop acreage base (other than property in the cash diversion program) for the farm on a bid basis. If a whole crop bid is made, the farmer offers to reduce his or her planted acreage of the crop to zero. As part of his or her bid, the farmer specifies the percent of the farm's program yield that he or she will accept as compensation. The lowest bids will be accepted first. If the whole base bid is accepted, the bid compensation rate applies to the entire PIK acreage. If the

¹ The term crop acreage base means the acreage devoted to production of the crop involved during a base period. The crop base is presently established under the Omnibus Reconciliation Act of 1982.

² The term farm program yield means the yield of the crop covered by a PIK contract on the farm property during an established historical reference period.

whole base bid is not accepted, the farmer is still entitled to PIK diversion of 10 to 30 percent of his or her crop acreage base at the established compensation rate for the crop involved.

Whether whole base PIK bids will be accepted depends on the amount of property for which PIK elections are made in the county where the property is located. The total acreage withdrawn from production of a crop under all Federal government land diversion programs cannot exceed 50 percent of the total acreage base for the crop in any county. All 10 to 30 percent elections will be accepted before any whole base bids are accepted.

If a farmer has a crop base in more than one crop included in the PIK program, he or she may elect to utilize the program for any combination or all of the crops. The total crop base diverted cannot, however, exceed the total acreage comprising the farm.

Property withdrawn from crop production under the PIK program must be devoted to conservation uses. Generally, this will result in the property being planted with a cover crop to prevent erosion and otherwise being permitted to lie fallow. The PIK acreage may be grazed other than during the six principal growing months of the PIK crop. Harvesting of any crop from land diverted under the PIK program generally will be prohibited.

Applications for both the guaranteed percentage PIK program and the whole base bid program must be submitted by March 11, 1983. All 1983 contracts must be signed by March 17, 1983. Whole base bids will be accepted or rejected at public county meetings on March 18, 1983. Executed PIK contracts are transferable by the farmer under certain circumstances; however, failure to comply with the contract terms can result in forfeiture of payments and, in certain cases, in liquidated damages.

Payment procedures.--Participating farmers will be eligible for payment-in-kind on a date established for their locality. The payment dates range from June 1 for wheat in certain Southern areas to November 1 for corn in certain Northern States. The payment availability dates reflect the usual harvest dates of PIK crops in different regions. Farmers may receive payment on the established availability date, or they may elect to defer receipt of the payment for any period of time up to 5 months thereafter. The Federal Government bears all risk of loss and storage costs until payment is received by the farmer.

The PIK commodities will be paid from surplus commodities held by the Federal Government. The Federal Government acquires these commodities through loan

cancellations in the crop loan and price support programs administered by the Commodity Credit Corporation ("CCC")³ and the Farmer-owned Reserve ("FOR").⁴ The CCC and FOR programs are similar, except CCC loans are normally made for a 9-month period while FOR stocks generally are held off the market for 3 years. In the case of payment from farm-stored FOR stocks, farmers will be paid an additional 7 months of storage costs beyond the normal 5 months allowed under the PIK program.

The method of payment under the PIK program will vary, depending on whether the farmer has outstanding loans with the CCC or has grain in the FOR. If the farmer has no commodities pledged under these programs, he or she will receive payment from government stocks of the commodity involved. If the farmer has commodities pledged under either of the programs, the payment will take the form of a 3-step transaction. First, the farmer will repay an amount of his outstanding loans equal to the PIK payment⁵. At that time, a pro rata portion of the loan security will be released. Second, the Government will repurchase the released commodities for an amount equal to the amount of the repaid loan (plus any accrued interest and storage charges paid by the farmer on repayment of the loan). Finally, the Government will return the commodities to the farmer as a payment-in-kind under the PIK contract.

Special procedures for upland cotton and rice.--PIK payments of upland cotton and rice generally will be made by the Government to a farmer's cooperative. If an upland cotton or rice producer markets his or her crop through a

³ The CCC is a Federally-owned corporation which administers the farm price support program through grants of loans on crops eligible for support. The CCC establishes an annual loan rate per unit for each crop eligible for government price supports. CCC then makes nonrecourse loans to farmers for their crops based upon this rate. If the market price for the crop rises above the loan rate, the farmer can redeem the crop, sell it, and retain any excess proceeds over the loan rate. If the market price does not rise above the loan rate before the loan's due date, the farmer can forfeit the crop to the Government in full satisfaction of the loan.

⁴ A portion of the commodities will be acquired through transactions, the substance of which is loan cancellation, with farmers who have such loans outstanding immediately before they receive payments of commodities under the PIK program.

⁵ Except in the case of upland cotton, the farmer can choose which loans to repay. Cotton loans must be repaid in the order in which the crops under loan were produced.

cooperative, the cooperative will receive the payment otherwise due the farmer under the PIK contract. Other farmers may elect to have cooperatives receive payments otherwise due them provided the farmers have no outstanding CCC loans themselves. The payment procedures for cooperatives will be the same as for individual farmers dealing directly with the Government. PIK payments to cooperatives will be held in pools separate from other crops held by the cooperatives.

Cash Payment Acreage Reduction Program

As stated in the Overview, farmers must participate in the cash payment acreage reduction program as a prerequisite of eligibility for the PIK program. This cash diversion program consists of two facets. First, the farmer must divert from production an established percentage of his or her acreage base in exchange for diversion payments.⁶ This required percentage varies with the crop--wheat, feed grains, corn, rice, and upland cotton. The payment is a statutorily prescribed amount per crop unit times the farm program payment yield for each acre diverted.

Second, the farmer must divert from production an additional percentage of his or her otherwise planted crop acreage for no pay. As with the so-called paid diversion, this no pay percentage varies with the crop involved (e.g., 12-1/2 percent for corn at the present time). These two diversion requirements generally result in approximately 20 percent of the farmer's crop acreage base being withdrawn from production in addition to any land so withdrawn under the PIK program. As with acreage in the PIK program, property withdrawn under the cash payment program must be devoted to conservation use.

Participation in the cash payment program also entitles the farmer to deficiency (price-support) payments with respect to crops actually produced. The deficiency payments are equal to the excess of an established "target" price over the greater of the year's CCC loan value for the crop or the crop's national average market price.

⁶ The Omnibus Reconciliation Act of 1982 authorized advance payment of prescribed percentages of payments for 1982 and 1983 crops (normally made in 1983 and 1984) during 1982. Additional advance payments of 1983 crops (normally made in 1984) are permitted in 1983. Advance payments are made at the option of the farmer.

III. PRESENT LAW

A. Income Tax Treatment of Farmers

1. Timing of Income

Generally, taxpayers engaged in farming may determine their income for Federal income tax purposes under either the cash or accrual method of accounting. However, corporations (other than certain "family owned" corporations, subchapter S corporations and certain corporations with annual gross receipts of less than \$1 million) and certain partnerships must use the accrual method of accounting for farm operations (Code sec. 447).

Under the cash method of accounting, income is recognized for the year in which it is actually or constructively received. Income is constructively received by a taxpayer when it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time (Treas. Reg. sec. 1.451-2(a)). A taxpayer who uses the cash method of accounting must recognize income when he is entitled to receive commodities under a payment-in-kind program.

Under the accrual method of accounting, income is generally recognized when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy, regardless of when received (Treas. Reg. sec. 1.451). A taxpayer who uses the accrual method of accounting must recognize income when he has the right to receive commodities under a payment-in-kind program, regardless of the time of actual receipt.

Thus, under both the cash and accrual methods of accounting, the taxpayer will recognize income when the commodities are made available to the farmer. In addition, under both methods, when property rather than cash is received, the amount to be included in income is the fair market value of the property on the date the taxpayer recognizes the income.

A taxpayer may elect to consider amounts received as loans from the CCC as income in the year in which received (Code sec. 77). If the election is made and the commodity securing such loan is later forfeited, no income would be recognized at the time of such forfeiture. If the election is made and the commodity securing the loan is later sold, the taxpayer's basis in the commodity is an amount equal to the income previously recognized in the year the loan

proceeds were received.

Generally, a taxpayer may elect to defer the income from the discharge of indebtedness on qualified business indebtedness. The deferral of the income is achieved by excluding the income from discharge of indebtedness (Code sec. 108) but with a corresponding reduction in the basis of certain assets (Code sec. 1017).

A farmer, who has commodities pledged for outstanding loans under the CCC or FOR programs, generally will receive his or her pledged commodity as a payment-in-kind under the PIK contract with a corresponding reduction in the amount of the CCC or FOR loan. However, as indicated in the discussion of the PIK program, this result will be achieved through a three-step process under which the loans are first repaid, followed by a purchase by the Federal Government of the commodity, and then a payment-in-kind of that commodity. It is unclear, under present law, whether such series of transactions will be treated as discharge of indebtedness or will follow the form of the transaction and be treated as a repayment of the loan by the farmer, a sale of the commodity to the CCC, and a return of the commodity to the farmer as a payment-in-kind.

2. Time for Payment of Tax

In general, a taxpayer is required to pay the tax shown on a tax return on the due date for filing the return (determined without regard to any extensions of time for filing the return). Corporations generally must pay at least 90 percent, and individuals 80 percent, of their current year's tax liability in quarterly estimated tax payments during the taxable year.

However, an individual whose estimated gross income from farming for the taxable year is at least two-thirds of his or her total estimated gross income from all sources for the taxable year (or whose gross income from farming shown on the preceding year's tax return is at least two-thirds of total gross income from all sources) must pay the estimated tax for a taxable year in full on or before January 15 of the succeeding taxable year.

Additionally, the requirement to make payments of estimated tax would be considered met if, on or before March 1, the taxpayer files a return for the taxable year for which estimated tax payments are required and pays in full the amount of tax due (Code secs. 6015(g), 6073(b), and 6153(b)). Corresponding payment dates would apply to taxable years beginning on a date other than January 1st. However, the addition to the tax with respect to underpayment of estimated taxes will not be imposed if the estimated tax payments are at least 66-2/3 percent of the tax liability for the year

(Code sec. 6654(d)).

3. Method of Accounting for Corporations Engaged in Farming

Generally, taxpayers engaged in farming may determine their incomes for Federal income tax purposes under either the cash or accrual method of accounting. However, corporations (other than certain "family owned" corporations, subchapter S corporations, and certain corporations with annual gross receipts of less than \$1 million) and certain partnerships that are engaged in the trade or business of farming are required to be on the accrual method (Code sec. 447).

4. Soil and Water Conservation Expenditures

Under present law, a taxpayer engaged in the business of farming may expense amounts which are paid or incurred during the taxable year for the purpose of soil or water conservation in respect of land used for farming, or for the prevention of erosion of land used for farming, but not in excess of 25 percent of the gross income derived from farming during the taxable year (Code sec. 175). Any amount not deductible in any taxable year because of the 25 percent of gross income limitation may be deducted in succeeding taxable years in the order of time so long as any taxable year's deductions under this provision do not exceed 25 percent of gross income from farming for that taxable year.

The term "land used in farming" means land used (before or simultaneously with the expenditures described above) by the taxpayer or his or her tenant for the production of crops, foods, or other agriculture products or for the sustenance of livestock.

Under present law, if a taxpayer disposes of farm land which he or she has held for fewer than 10 years, a certain proportion of the gain realized on the disposition is treated as ordinary income (Code sec. 1252). That proportion is the lower of a percentage of the aggregate deductions allowed under sections 175 and 182 for expenditures made with respect to the farm land after 1969, or the excess of the amount realized (or the fair market value) over the adjusted basis of such land. For this purpose, the term "farm land" is land with respect to which deductions have been allowed under sections 175 or 182.

5. Expenditures by Farmers for Fertilizer, etc.

Under present law, a taxpayer engaged in the business of farming may elect to expense amounts that otherwise must be capitalized which are paid or incurred

during the taxable year for materials to enrich, neutralize, or condition land used in farming, or for the application of such materials to the land (Code sec. 180). For this purpose, land is used in farming if it is used, either before or simultaneously with the expenditures described above, by the taxpayer or his or her tenant for the production of crops, fruits, or other agricultural products, or for the sustenance of livestock.

6. Expenditures by Farmers for Clearing Land

Under present law, a taxpayer engaged in the business of farming may elect to treat expenditures paid or incurred in a taxable year to clear land for the purpose of making such land suitable for use in farming as a currently deductible expense (Code sec. 182). However, this deduction for any taxable year may not exceed the lesser of \$5,000 or 25 percent of the taxable income derived from farming during the taxable year (as defined). Such expenditures are subject to recapture under section 1252 (see item 4, above).

7. Activities Not Engaged in for Profit

Under present law, if an individual or a Subchapter S corporation engages in an activity not for profit, no deduction (other than itemized deductions) attributable to such activity is allowable in excess of the income from that activity (Code sec. 183).

8. Gain from Disposition of Property Used in Farming or Farm Losses Offsetting Farm Income

Under section 1251, any person carrying on a trade or business of farming, other than any person utilizing the accrual method of accounting, is required to maintain an excess deductions account (EDA). Prior to taxable years beginning after December 31, 1975, any person having a farm net loss (the excess of farm deductions over gross income derived from farming), was obligated to add such amount to his EDA.

If, at the end of any taxable year, the EDA has a positive balance, then the amount of the EDA is reduced (1) for any farm net income (the excess of farming gross income over farm deductions for that taxable year), (2) for any amounts with respect to deductions which do not result in a tax deduction for the taxpayer, and (3) the amount realized from the sale, exchange, or involuntary conversion of farm recapture property. Farm recapture property includes depreciable personal property held for more than one year, certain cattle or horses, land held for more than one year, and unharvested crops growing on land which has been held for more than one year.

9. Qualification of Corporations for Subchapter S Status

Under present law, certain closely held corporations (commonly called "subchapter S corporations") can elect to have their income taxed to the shareholders and not the corporation, regardless of whether or not it is actually distributed during the year (Code sec. 1371-9).

One requirement for electing subchapter S status for corporations which had accumulated earnings and profits while it was not a subchapter S corporation is that during the last three taxable years prior to the election no more than 25 percent of the gross receipts of the electing corporation be passive investment income. Passive investment income is defined to include gross receipts received from rents.

10. Self-employment Income

A self-employment tax is imposed on net earnings from self-employment as defined by section 1402. Net earnings from self-employment means gross income derived by an individual from any trade or business, less allowable deductions attributable to such trade or business. Rentals from real estate including rentals paid in crop shares are excluded in determining net earnings from self-employment, unless such rentals are received in the course of a trade or business as a real estate dealer. However, this exemption does not apply to any income derived by a landlord if (1) the income is derived under an arrangement entered into between the landlord and another individual which provides for the landlord's material participation in the production or management of the production of the agricultural or horticultural commodities to be produced on the land by the individual, and (2) there is material participation by the landlord with respect to any such commodity. Thus, income which is received by a farmer who materially participates in the production of the income is treated as self-employment income.

11. Limitation on Deduction of Investment Interest

In general, all interest paid or accrued during the taxable year on indebtedness is allowable as a deduction. However, if a taxpayer other than a corporation pays or accrues an amount of investment interest, then the otherwise allowable deduction with respect to that interest cannot exceed \$10,000 (\$5,000 in the case of a separate return by married individual), plus net investment income.

Investment interest is interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment. Net investment income means

gross income from interest, dividends, rents, and royalties, and certain other income from passive sources, to the extent it exceeds investment expense. Investment expense means certain expenses deductible under various provisions of the Internal Revenue Code attributable to investment items.

12. Imposition of Tax on Unrelated Business Income of Charitable, etc. Organizations

A tax is imposed for each taxable year on the unrelated business taxable income of certain exempt organizations. The term "unrelated business taxable income" means the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less deductions allowed which are directly connected with the carrying on of such trade or business. In general, however, all rents from real property are excluded from the computation of unrelated business taxable income.

13. Imposition of Personal Holding Company Tax

An additional tax is imposed on the undistributed personal holding company income of every personal holding company. This tax is equal to 50 percent of the undistributed personal holding company income.

In general, a personal holding company is any corporation, other than certain specified types of corporations, at least 60 percent of the adjusted ordinary income of which is personal holding company income. In addition, more than 50 percent in value of the outstanding stock of a personal holding company must be owned, directly or indirectly, by 5 or fewer individuals during the last half of the taxable year. The term "personal holding company income" includes adjusted income from certain rents and royalties.

B. Tax Treatment of Cooperatives

A cooperative is an organization, usually operating in corporate form, which is established and operated for the mutual benefit of its members and patrons by selling goods to them or purchasing products from them and returning to them any income in excess of costs. Unlike other corporations, a cooperative is allowed a deduction from its taxable income to the extent patronage source income is distributed to its members or patrons as a patronage dividend or in redemption of a non-qualified written notice of allocation. Additionally, a cooperative may exclude income attributable to qualified per-unit retain allocations and redemptions of nonqualified per-unit retain certificates. Patronage

dividends (whether paid in cash, in qualified written notices of allocation, or in redemption of nonqualified written notices of allocation) are includible in the income of a member or patron when paid or allocated. In general, an amount is a patronage dividend if it is payable out of patronage source income to all patrons of the cooperative⁷ equally on the basis of business done with or for patrons. A per-unit retain allocation is, in general, an amount retained by the cooperative with respect to goods marketed by the cooperative for the patron.

Patronage source income is income directly related to business done with or for patrons. Thus, for example, investment income and income derived from the sale or exchange of capital assets is nonpatronage source income. A patron is any person doing business with the cooperative on a mutual basis.

Exempt farmers' cooperatives are allowed more beneficial tax treatment than nonexempt cooperatives in two respects. First, they are allowed a deduction for dividends paid from nonpatronage source income (including income from business done with or for the United States) to their patrons (not including the United States or its agencies). Second, they are allowed a deduction for amounts paid as dividends on their capital stock during the taxable year as long as the dividends do not exceed the greater of 8 percent or the legal rate of interest in the State of incorporation.

A nonexempt cooperative is any cooperative other than an exempt farmers' cooperative. Nonexempt cooperatives cannot deduct dividends of nonpatronage source income, but they are not limited in the sources or amounts of their nonpatronage source income.

C. Estate Tax Treatment of Farmers

1. Current Use Valuation of Certain Farm Real Property

Qualification of Decedent's Estate

For estate tax purposes, real property ordinarily must be included in a decedent's gross estate at its fair market value based upon its highest and best use. If certain

⁷ A patronage dividend must be payable (1) on the basis of the quantity or value of business done with or for the patron, (2) under an obligation to pay such amount which obligation existed when the cooperative received the amount, and (3) with reference to the net earnings of the cooperative from business done with or for its patrons.

requirements are met, however, real property used in family farm operations and other closely held businesses may be included in a decedent's estate at its current use value, rather than its full fair market value. The maximum reduction in value permitted under the current use valuation provision is \$750,000 per estate (Code sec. 2032A).

One of the requirements for specially valuing property is that minimum percentages of the decedent's estate must consist of real property which, among other attributes, has been used in a "qualified use" during certain specified periods. First, at least 50 percent of the adjusted value⁸ of the decedent's estate must consist of the adjusted value of real and personal property used in a qualified use on the date of the decedent's death. Second, at least 25 percent of the adjusted value of the decedent's estate must consist of real property used in a qualified use. Third, all real property to be specially valued must have been used in a qualified use both on the date of the decedent's death and for periods aggregating at least 5 years of the 8-year period ending on the date of death.

Another requirement is that the decedent or a member of his or her family must materially participate in the farming operation in which the real property to be specially valued is used. Material participation must occur during periods aggregating at least 5 years of the 8-year period ending on the date of the decedent's death. A special rule for individuals who are retired or disabled on the date of their deaths permits the material participation requirement to be satisfied by disregarding periods after the individuals began receiving social security benefits or became disabled, if the retirement or disability was continuous until the date of death.

Recapture of Tax Savings in Certain Circumstances

If, within 10 years⁹ after the death of the decedent (and before the death of the heir receiving the property), specially valued property is disposed of to nonfamily members or ceases to be used for the farming or other closely held business purpose based upon which it was valued in the decedent's estate (i.e., its "qualified use"), all or a

⁸ The adjusted value of a decedent's estate is equal to the gross value of the estate minus indebtedness payment of which is secured by property in the estate. Similarly, the adjusted value of an asset is equal to the gross value of the asset minus indebtedness payment of which is secured by the asset.

⁹ The recapture period is 15 years in the case of estates of decedents who died before 1982.

portion of the Federal estate tax benefits obtained by virtue of the reduced valuation are recaptured by means of a special "additional estate tax" or "recapture tax." During the recapture period, the qualified use requirement must be satisfied at all times.¹⁰

The recapture tax is imposed on the qualified heir rather than the decedent's estate. However, the tax liability is measured by reference to the estate tax saved by the decedent's estate. In the case of a partial cessation of qualified use, the recapture tax is prorated based upon the percentage of the specially valued property that is no longer used in the qualified use.

Material participation in the farm operation is also required during the recapture period. Except in the case of "eligible qualified heirs,"¹¹ the heir receiving the property or a member of the heir's family must materially participate in the farm operation for periods aggregating at least 5 years of every 8-year period ending after the date of the decedent's death and before expiration of the recapture period. Failure to satisfy the material participation requirement during the recapture period is deemed to be a cessation of qualified use.

Definition of Qualified Use

The term qualified use has the same meaning under both the pre-death requirement and the recapture period requirement. In general, a qualified use is a use in farming or in another closely held business. The business in which specially valued real property is used must be an active operation, as opposed to a passive investment activity. In the case of farms, the activity requirement is normally satisfied by the production of crops or raising of animals for profit.¹²

¹⁰ A special rule disregards a period beginning on the decedent's date of death and ending not more than 2 years later; however, the recapture period is extended by a period equal to any part of this 2-year period when the qualified use requirement is not satisfied.

¹¹ An eligible qualified heir can satisfy the material participation requirement through "active management," a lesser standard of personal involvement than material participation. Eligible qualified heirs include surviving spouses, minors, full-time students, and disabled individuals.

¹² A so-called "hobby farm" which is an activity not engaged
(Footnote continued)

Additionally, the decedent or a family member (during pre-death periods) and each qualified heir owning a present interest in the property (during the recapture period) must own an equity interest (i.e., be at risk) in the business operation. The element of risk must be as to both price and production. Thus, for example, the qualified use requirement is not satisfied during any periods when the party who is to satisfy the qualified use requirement withdraws the property from productive use¹² or leases the property pursuant to a net cash or other fixed return lease.

Because real property is withdrawn from crop production under the payment-in-kind ("PIK") program in exchange for a fixed payment, such real property may not be considered to be used in a qualified use.

Definition of Material Participation

Material participation means personal involvement in an active farming operation to a material degree. The determination of whether this requirement is satisfied is factual and is based on factors such as participation in making business decisions, inspection of crops, and other farm activities in which the participant engages.

Material participation for purposes of the current use valuation provision is defined by reference to the meaning of the same term as used in the social security tax provisions. Therefore, the participant's activity must be sufficient to convert his or her income from "passive rentals" to "earned income" for purposes of the self-employment income (SECA) tax. As earned income, the farm income is subject to the SECA tax. In addition, for certain persons under age 70, social security benefits may in some cases be reduced if this income exceeds prescribed amounts.

It is unclear under present law whether management of land withdrawn from production under the PIK program is used in a farming operation involving sufficient personal involvement to constitute material participation.

¹² (continued)
in for profit under section 183 does not satisfy the qualified use requirement (Treas. Reg. sec. 20.2032A-3(b)(1)).

¹³ Property permitted to lie fallow during nonproducing seasons or as part of a regular crop rotation program is treated as satisfying the requirement during these temporary periods.

2. Installment Payment of Estate Tax

Overview

In general, estate tax must be paid within 9 months after a decedent's death. However, if at least 35 percent of the value of the decedent's adjusted gross estate is comprised of the value of an interest in the closely held business and if certain other requirements are satisfied, payment of estate tax attributable to the interest in the closely held business may be extended and paid in installments during up to 14 years (interest for 4 years followed by from 2 to 10 annual payments of principal and interest). The determination of whether the decedent owns an interest in a closely held business is made as of the decedent's date of death (Code sec. 6166).

A special 4-percent interest rate is provided for estate tax attributable to the first \$1 million in value of the closely held business interest (Code sec. 6601(j)). Tax in excess of this amount (\$345,000 of tax less the amount of decedent's unified credit) accrues interest at the regular rate charged on deficiencies (Code sec. 6601(a)). The regular deficiency rate currently is 16 percent.

Under present law, proprietorships owned by the decedent may qualify as an interest in a closely held business. In addition, an interest in a closely held business may include interests in partnerships and corporations if certain "percentage tests" or "numerical tests" are satisfied.

Definition of trade or business

Only interests in active trades or businesses, as contrasted to passive investment assets, are eligible for the installment payment provision. The determination of whether an interest in an active trade or business is present is factual and must be made on a case-by-case basis.

In Revenue Ruling 75-366, 1975-2 C.B. 472, the decedent leased real property to a tenant on a crop share basis. In addition to sharing in the farm expenses and production, the decedent actively participated in important management decisions. The Internal Revenue Service ruled that the decedent was in the business of farming under these facts stating:

An individual is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant, and if he receives a rental based upon farm production rather than a fixed rental. Farming under these circumstances is a productive enterprise which is like a manufacturing enterprise as distinguished from management of

investment assets.

In the present case, the decedent had participated in the management of the farming operations and his income was based upon the farm production rather than on a fixed rental.

Accordingly, the farm real estate included in the decedent's estate qualifies...as an interest in a closely held business. (Id.)

IV. Issues Presented by the PIK Program

A. Income Tax Treatment of Farmers--Timing of Income

The first issue raised by the PIK program is whether a farmer should recognize income from participation in the PIK program at the time he or she is entitled to receive the commodity, at the time he or she actually receives the commodity, or at the time he or she disposes of the commodity.

B. Income Tax Treatment of Farmers--Miscellaneous Issues

The second issue is whether income derived from the sale or other disposition of PIK commodities should be treated as gross income from farming and whether land diverted from production under the PIK program should be treated as land used in the trade or business of farming under a number of provisions of the Code. These provisions include, but are not limited to:

- (1) payments of estimated tax;
- (2) method of accounting by corporations engaged in farming;
- (3) expensing of certain soil and water conservation expenditures;
- (4) expensing of certain expenditures by farmers for fertilizer;
- (5) expensing of certain expenditures by farmers for clearing land;
- (6) deductibility of expenses attributable to activities not engaged in for profit;
- (7) gain from disposition of property used in

farming or farm losses offsetting farm income;

(8) qualification of corporations for subchapter S status;

(9) application of self-employment tax;

(10) limitation on deduction of investment interest;

(11) tax on unrelated business income of charitable, etc., organizations; and

(12) tax on personal holding companies.

C. Income Tax Treatment of Farmers--Treatment of Cooperatives

The third issue is whether the income derived from the sale or the disposition of PIK commodities received by a producer and marketed through a cooperative, or received directly by a cooperative on behalf of the producer, should be treated as patronage source income.

D. Estate Tax Treatment of Farmers

The fourth issue is whether the requirement that all specially valued real property be put to productive use in an active business operation in which the decedent or a member of his or her family (during pre-death periods) or the qualified heir (during the recapture period) is at risk should be modified to permit property that is withdrawn from production in exchange for a fixed payment-in-kind by the Federal Government to qualify for current use valuation.

The fifth issue is whether the current use valuation material participation requirement should be modified to provide that material participation is present with respect to farm real property that is withdrawn from production in exchange for a fixed payment-in-kind by the Federal Government.

The sixth issue is whether land diverted from production under a fixed payment-in-kind program should qualify for installment payment of estate tax.

V. DESCRIPTION OF THE BILLS

A. Description of S. 446

1. Income Tax Treatment of Farmers--Timing of Income

S. 446 would provide that a taxpayer who receives any commodity under a certified payment-in-kind program would not recognize income by reason of the right to receipt of such commodity until the commodity is sold or exchanged. Thus, both accrual and cash basis taxpayers could defer the recognition of income, that would otherwise be recognized under current law in the year the taxpayer has a right to receive the commodities until the year the commodities are sold or exchanged.

For purposes of determining the amount of gain from a sale or exchange of the commodities, the taxpayer would be treated as having zero basis in the commodity. Such gain would be treated as ordinary income.¹⁴

These provisions would apply to taxable years beginning after December 31, 1982.

2. Estate Tax Treatment of Farmers--Current Use Valuation

S. 446 would provide that commodities received under a certified payment-in-kind (PIK) program are treated as produced by the recipient on the real property withdrawn from production under the PIK program. Therefore, under the current use valuation provision, the real property would be treated as used in an active farming (i.e., qualified) use during periods when it was withdrawn from production under the PIK program for the following purposes:

- (1) Determining whether real property was used in a qualified use for periods aggregating at least 5 years of the 8-year period ending on the decedent's date of death;

¹⁴ This bill does not address the proper treatment of income derived from the sale or other disposition of commodities received under a payment-in-kind program (or the treatment of land diverted from production under such a program) for other purposes of the Code. Also, this bill does not address the proper treatment of cooperatives (both exempt and non-exempt) marketing PIK commodities received, by or on behalf, of a farmer participant.

(2) Determining whether the real property was used in a qualified use on the decedent's date of death; and

(3) Determining whether the real property was used in a qualified use during the post-death recapture period.¹⁵

This provision would apply to estates of individuals dying after December 31, 1976.

B. Description of S. 495

1. Income Tax Treatment of Farmers--Timing of Income

S. 495¹⁶ would provide an election for a taxpayer who would otherwise be required to recognize income under present law on receipt of any agricultural commodity under a Federal farmland removal program to treat the commodity as if it were produced by the taxpayer. If the taxpayer elects this treatment, both accrual basis and cash basis taxpayers would recognize income when the commodity is sold. For purposes of determining the amount of gain on the disposition of the commodity, the taxpayer's basis in the commodity would be zero.

This bill would also provide an election for a taxpayer who would otherwise be required to recognize income by reason of the cancellation of a qualified support loan. The taxpayer could elect to recognize income in the year the commodity which secures the loan is disposed of (or consumed). The amount to be included in income in a year would bear the same ratio to total income from the cancellation of the loan as the amount of the commodity sold in such year bears to the total amount of the commodity which secured the loan.

These elections could be made separately with respect to each receipt of a commodity and each loan cancelled.¹⁷

¹⁵ This bill does not address qualification of PIK real property for the estate tax installment payment provision.

¹⁶ S. 495 is substantially similar to H.R. 1296 introduced in the House of Representatives by Congressman Harkin and others on February 7, 1983.

¹⁷ S. 495 does not address the proper treatment of income derived from the sale or other disposition of commodities received under a certified payment-in-kind program (or the treatment of land diverted from production under such a program) for other purposes of the Code. Also, this bill does not address the proper treatment of cooperatives (both exempt and non-exempt) marketing PIK commodities received, by or on behalf, of a farmer participant.

These provisions would apply to taxable years ending after December 31, 1982.

1. Estate Tax Treatment of Farmers--Current Use Valuation

S. 495 would provide that, for purposes of the current use valuation provision, real property withdrawn from production under any Federal farmland removal program in exchange for any fixed payment from the Federal Government would be treated as used in an active farming (i.e., qualified) use during periods when it was withdrawn from production under the Federal program for the following purposes:

(1) Determining whether real property was used in a qualified use for periods aggregating at least 5 years of the 8-year period ending on the decedent's date of death;

(2) Determining whether the real property was used in a qualified use on the decedent's date of death; and

(3) Determining whether the real property was used in a qualified use during the post-death recapture period.

S. 495 would also provide that removal of real property from production under any Federal farmland removal program would not be construed to prevent satisfaction of the material participation requirements of the current use valuation provision.

These provisions of the bill would apply to estates of individuals dying after December 31, 1982.

C. Description of S. 527

1. Income Tax Treatment of Farmers--Timing of Income

S. 527 would provide that a taxpayer who receives, or is entitled to receive, any commodity under a payment-in-kind program would not be required to recognize income by reason of such receipt or entitlement until the commodity is sold or exchanged. Thus, both accrual and cash basis taxpayers would defer the recognition of income, that would otherwise be recognized under current law in the year the commodities, are entitled to be received, until the year the commodities are sold or exchanged.

For purposes of determining the gain or loss from the

sale or other disposition of the commodity, the basis of the commodity would be zero. The commodity would be treated as produced by the taxpayer for purposes of determining the character of the gain (ordinary income or capital gain) from the sale of the commodity or, if the commodity is used by the farmer (e.g., as feed), from the sale of the property (e.g., livestock) the basis of which includes the basis of the commodity.

As discussed in Part II (Description of the Payment-in-kind (PIK) Program), the payment-in-kind of a commodity where there are outstanding CCC (or FOR) loans may involve a 3-step process: the repayment by the taxpayer of a loan from the CCC, the purchase by the CCC of the commodity securing the loan, followed by the receipt (or entitlement to receipt) of the commodity by the taxpayer as a payment-in-kind. In any such case, the taxpayer who receives the commodity, as payment-in-kind in the third step of this 3-step process, would be entitled to the same tax treatment on such receipt as a taxpayer who receives a payment-in-kind where a CCC loan is not involved.

If, with respect to the CCC loan, the taxpayer had made an election under section 77 to recognize income in the year the loan proceeds were received, the repayment of the loan and the purchase by the CCC of the commodity (the first and second steps of the 3-step process) would be treated as a transaction closing the sale of the commodity. The taxpayer would not recognize income, as under present law, at the time of such closing because the taxpayer would have already recognized income when the loan proceeds were received.

In the case of a taxpayer who had not made such an election under section 77, the repayment of the CCC loan and the purchase by the CCC of the commodity securing the loan (the first and second steps of the 3-step process) would be treated as a sale of the commodity by the taxpayer. The taxpayer would recognize income, as under present law, at the time of such sale.

As part of the payment-in-kind program, the taxpayer may receive reimbursement for storage costs. The bill would provide that a cash basis taxpayer would not be treated as being entitled to receive (thus, constructively receive) any amount as reimbursement for storage until such amount is actually received.

2. Social Security Act

Under the bill, income from the sale or exchange of any PIK commodity is treated as income for the trade or business of farming. Therefore, such income is subject to the tax on net earnings from self-employment.

3. Treatment of PIK Payment for Other Tax Purposes

Under the bill, for all purposes of the Internal Revenue Code, income from the sale or exchange of PIK commodities is treated as income from the trade or business of farming and the taxpayer is treated as using in the trade or business of farming any land diverted from production under any certified payment-in-kind program. Thus, income with respect to the sale or exchange of commodities received under a certified payment-in-kind program would be treated as gross income from farming for all purposes of the Code, including the requirement for estimated tax payments; determining the proper method of accounting for farming corporations and others; determining the deductibility of certain soil and water conservation expenditures; determining the deductibility of expenditures by farmers for amounts to enrich, neutralize, or condition the land; determining the deductibility of expenditures by farmers for clearing land; determining whether or not an activity is one engaged in for profit; determining whether or not any recapture is owing with respect to the disposition of farming property; and for determining the amount (if any) of the passive income earned by any corporation during the three taxable years before an election by such corporation to be taxed under subchapter S. In addition, income received in respect to marketing commodities received under any certified payment-in-kind program would be treated as income from a nonpassive source for determining the limitation for the deduction of investment interest; the imposition of the tax on unrelated business income to charitable organizations; and the imposition of the personal holding company tax.

4. Taxation of Cooperatives

Under the bill, income derived by a cooperative (whether exempt or non-exempt) from marketing any commodity received as a payment-in-kind under a certified payment-in-kind program by a member or patron of the cooperative and sold or assigned to the cooperative would be treated as patronage source income from the sale or other disposition of commodities produced by the patron participating in the program. In addition, if a cooperative (whether exempt or non-exempt) received a payment-in-kind under a certified payment-in-kind program directly from the Commodity Credit Corporation (CCC) on behalf of a member or patron because the member or patron had assigned his right to receive the payment to the cooperative, or because the member or patron was required to receive the payment through his cooperative, then the proceeds of the sale or other disposition of such commodities will also be treated as patronage source income from the marketing of a commodity produced by the member-participant.

Thus, income received with respect to the marketing of

PIK commodities would be deductible to both exempt and nonexempt cooperatives. Further, the tax status of exempt farmers' cooperatives would not be endangered by marketing PIK commodities.

Under the bill, if a cooperative has a CCC loan outstanding, and is required, as a condition to its participation in the PIK program, to pay off all or a portion of such loan and then sell the commodity which had been pledged as security for that loan back to the CCC for the same amount as the loan pay-off, the characteristic of the gain realized on such sale or other disposition will be determined with reference to the character, as patronage source or non-patronage source, of the commodity which is sold. Also, as with farmer-participants, the transaction will be treated as a closing-out of the loan and not a discharge of indebtedness.

As is the case with farmer-participants, storage fee reimbursements received by cash basis cooperatives will not be taxable until actually received.

5. Estate Tax Treatment of Farmers

Current use valuation

S. 527 would provide that, for purposes of the current use valuation provision, real property withdrawn from production under a payment-in-kind (PIK) program would be treated as used in an active farming (i.e., "qualified") use during a continuous period not exceeding three years from the time the real property was first withdrawn from production under a PIK program. This treatment would apply for the following purposes:

- (1) Determining whether the real property was used in a qualified use for periods aggregating at least 5 years of the 8-year period ending on the date of the decedent's death;
- (2) Determining whether the real property was used in a qualified use on the decedent's date of death; and
- (3) Determining whether the real property was used in a qualified use during the post-death recapture period.

The bill would also provide that the material participation requirements of the current use valuation provision are deemed to have been satisfied by the recipients of commodities under a PIK program. (See above for a discussion of the treatment of these payments-in-kind for self-employment tax purposes.)

Installment payment of estate tax

S. 527 would provide that, for purposes of the estate tax installment payment provision, real property otherwise used in an active trade or business would not be treated as withdrawn or diverted from the active business use by reason of its withdrawal from production under a PIK program.

Effective date

The estate tax provisions of the bill would apply to real property diverted from production under a PIK program in exchange for commodities received after December 31, 1982, and before April 1, 1986.

VI. Prior Congressional Action on the PIK Program

On February 23, 1983, the Subcommittee on Select Revenue Measures of the Committee on Ways and Means ordered reported to the full committee a bill, H.R. 1296, with amendments, addressing the tax issues arising from the PIK Program and another matter.

A. PIK Tax Treatment Provisions

Under the subcommittee amendment, recognition of income from commodities received in the 1983 PIK Program would be deferred from the date the commodities are received (or constructively received) until the date on which the commodities are sold.

Real property withdrawn from production in exchange for a payment-in-kind under the 1983 PIK Program would be treated as used in an active farming (e.g., qualified) use by the person entering the PIK contract for purposes of the estate tax current use valuation and installment payment provisions. Additionally, an individual who materially participates in the conservation use to which real property withdrawn from production under the 1983 PIK Program is devoted would be treated as materially participating in a farming operation in which the PIK property is used.

The subcommittee bill generally would treat income from PIK commodities as active income derived from the business of farming for all other purposes under the Internal Revenue Code.

For purposes of the self-employment income (SECA) tax and the social security benefit provisions, income from PIK commodities would be treated as "earned" income to persons who materially participate in the conservation use to which the PIK real property is devoted.

Rules would be provided treating commodities received under a PIK program by a cooperative as patronage source income from the sale of commodities produced by the cooperative's patrons.

The subcommittee amendment also includes a special anti-speculation rule that limits the income and estate tax provisions to land acquired by any person before February 24, 1983, unless the acquisition occurs by reason of death, by reason of gift, or from a member of the transferee's family. Mere changes in form are not treated as transfers if the transferor retains at least a direct or indirect 80-percent interest in the land. Under this rule, acquisition of an

80-percent or more interest in a crop from any land is treated as acquisition of the land.

Finally, a study of the effects of the PIK program and the tax treatment under the bill would be required from the Secretary of the Treasury no later than September 1, 1983.

The income tax provisions of the bill would apply to PIK payments for the 1983 crop year, including PIK payments for crops normally planted before December 31, 1983. The estate tax provisions would apply to real property withdrawn from production in respect of such crops.

B. Exemption of Certain Agricultural Organizations

The subcommittee amendment would exempt from tax certain agricultural organizations operated on a nonprofit basis primarily for collectively bargaining with respect to unprocessed agricultural commodities produced by their members, effective for taxable years beginning after December 31, 1983.